

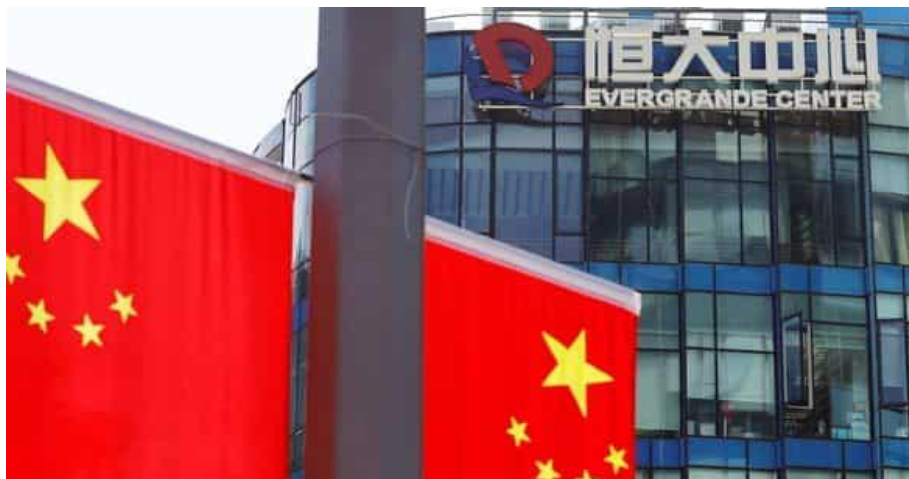


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Eurasia Brief

Overview of China's Real Estate Industry during the Pandemic



Chinese flag and Evergrande Center, Wan Chai district of Hong Kong, its sale collapsed. Photo Credit - Reuters

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Chinese flag and Evergrande Center, Wan Chai district of Hong Kong, its sale collapsed. Photo Credit - Reuters

Introduction

The Chinese economy has kept one of the highest rates of economic growth around the globe. However, plenty of reasons impede it from continuing. Like most countries, the Covid-19 Pandemic that broke out in 2019 is a critical factor that cannot be neglected. However, unlike many countries that have returned to a rather normal life, China keeps the strictest preventive Covid policy in response, including mandatory tests and frequent lockdowns. These policies affect all economic activities, especially in the real estate industry. In addition, even before the pandemic, the Chinese government started adjusting the whole economic structure with radical policies. Evergrande is the first real estate giant that encountered a crisis after failing to repay its debts and being overdue on several projects. While Evergrande has its internal issues, this article focuses more on the whole real estate industry's changing dynamic.

Overview of the Real Estate Industry

Before the pandemic, the real estate sector is one of the leading contributors to the Chinese economy's growth over the past 20 years. It directly occupies approximately 7.34% of the total

GDP. The number can increase to almost 20% of all the indirect and related industries. Real estate was nearly 59.1 % of the total wealth of a residential family, which is 28.5% higher than a U.S. residential family. In addition, most real estate companies hold significant debt for their expansion and new projects. And since the financial market in China is more rigorously regulated than in other places, most companies turn to international loans. The connection with the freer financial environment abroad brings vulnerability. Any fluctuation in the global market can become a devastating crisis for large Chinese real estate companies, which in turn affect the whole economy. Many economists regard the dependency on real estate as critical alarming to the unhealthy economic structure. The Chinese government is also aware and implementing several policies to prevent its deterioration.

Beijing attempted to deleverage the real estate industry to promote a more comprehensive economy. The most critical one is the three red lines Beijing drew for real estate companies in August 2020 related to debt, assets and cash. Firstly, liabilities should not exceed 70% of total assets. Secondly, net debt should be at most 100% of equity. Finally, cash reserves should be at most 100% of short-term liabilities. If a company qualifies for all three guidelines, it is classified as a green-class firm that can have a growth ratio of interest-bearing debts no greater than 15%. If a company qualifies two of them, it is classified as an orange-class firm than can have a growth ratio of interest-bearing debts no greater than 10%. If a company qualifies as one of them, it is classified as an orange-class firm than can have a growth ratio of interest-bearing debts no greater than 5%. If a company fails in every line, it cannot increase the size of interest-bearing debts. Only five of the 30 largest real estate companies are qualified as a green class. Evergrande, one of the other five, failed in all three lines. The strict limitation against the obtaining loans kept pressure on Evergrande, which directly triggered its collapse.

Another significant trend is the increase in government involvement accompanied by shrinking private companies involvement in the industry. For example, in Guangzhou, where Evergrande is headquartered, the city's first land auction was held in May. Of the 18 land parcels, about 15 were acquired by local or central government-owned companies. Guangzhou Metro, a metro operator with a property development business, won four bids. This was different from the case two years ago. Ten of 11 land parcels were bought by private companies. In the first four months of 2022, all but eight of the top 20 developers who participated in land auctions in the past four months have government backgrounds.



CR Land as one of the largest state-own property developers Photo Credit: Costfoto: Zuma Press

The roots of these moves are Chinese leaders' distrust of domestic entrepreneurs and their fast-growing businesses. The Chinese government has criticized the “disorderly expansion” of capital. It has launched a regulatory overhaul of internet technology platforms, education and training institutions, and other industries dominated by private companies. China's real estate sector has expanded massively over the past decade and is now dominated by private companies. But recently, the Chinese government reiterated its official stance that houses are for housing instead of speculating, a sign that the government wants a stable housing market. Since the housing market cooled last summer, the Chinese government has encouraged state-owned housing companies to play a more active role in the sector. However, rather than trying to bail out private rivals, state-owned developers may take advantage of the industry's overall woes to benefit by buying high-quality assets at low prices.

Evergrande as a Typical Case

Founded in 1996, Evergrande grew during the epoch-making prosperity of China's real estate industry. The real estate industry had urbanized large areas of China and linked nearly 75% of family wealth to real estate. This has made Evergrande a core force in the Chinese economy, which once relied on the real estate market for robust economic growth. Evergrande is China's second-largest real estate company, with more than 1,300 projects in its territory in 280 cities. Its assets are reported to be around 2 trillion yuan (about 310 billion U.S. dollars), which is almost 2% of China's GDP. In addition to its core business of real estate, Evergrande is also involved in many other fields, including electric vehicles, food and beverages, and even theme parks and football clubs.



Evergrande's luxury-class project in Guangzhou in 2009 Photo Credit: Alex Hofford, NYT

In addition to assets, like many other real estate companies, Evergrande's survival depends on large loans. Evergrande founder and billionaire Xu Jiayin, is a member of the Chinese People's Political Consultative Conference, an elite group of advisers with good political connections. Xu Jiayin's connections will likely give creditors more confidence to keep lending to Evergrande as it develops and expands new businesses. Another method for Evergrande is to borrow money from banks or other channels and, simultaneously, receive a deposit from the buyer, who also needs a loan to pay Evergrande. Evergrande is borrowing new debt to repay the loan, similar to a Ponzi scheme. More projects require more loans. This gave Evergrande more low-cost borrowing options, helping its rapid growth. Evergrande only has cash that can last for one year on its books. This is a big worry for investors. Evergrande has missed the payment deadline twice. Jiayin is not alone on the road that Evergrande has taken. Many Chinese real estate companies adopt a similar risk model of high debt and turnover. The difference is that Evergrande has a higher obligation, faster turnover, more land acquisition, and greater risk. Evergrande owes about \$300 billion, which is a considerable amount compared to the debts of other real estate companies.

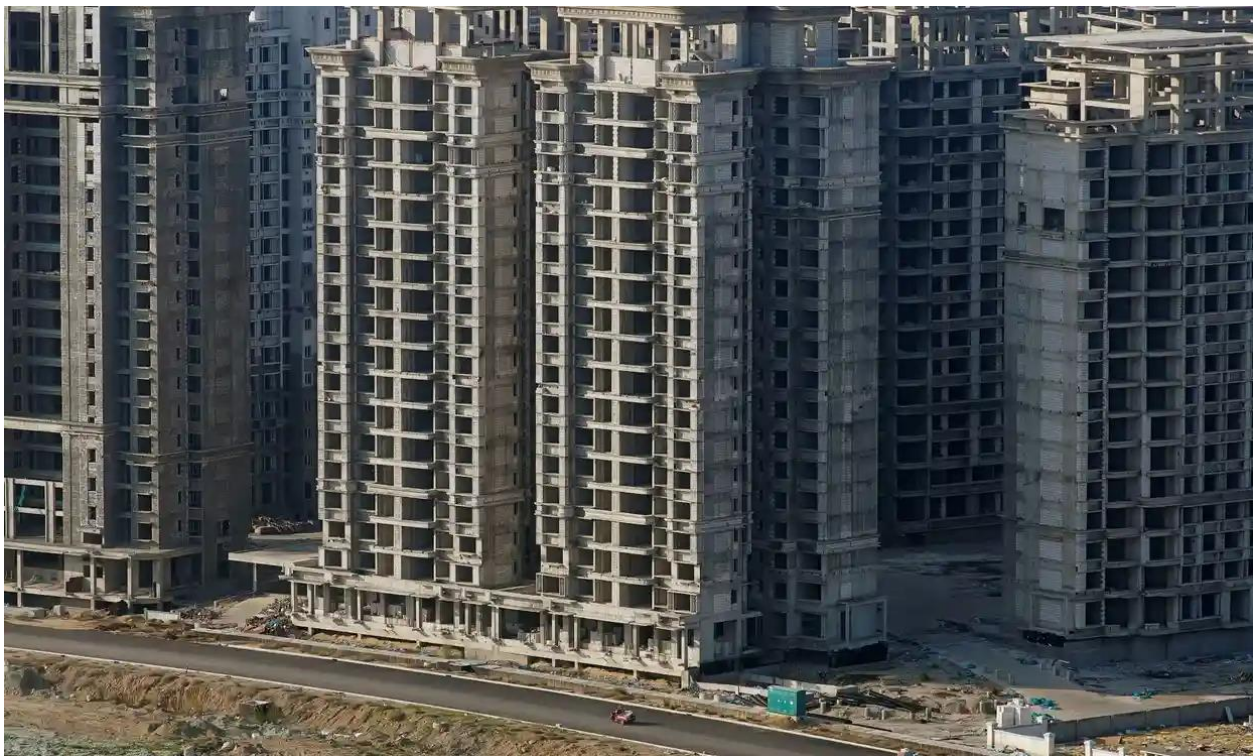


A senior manager in Evergrande sits on the floor exhausted by consumers' complaints. Photo Credit: Reuters

Among all the critical causes, two of them stand out. The first one is that the Chinese regulators are cracking down on the reckless lending habits of property developers. That has forced Evergrande to start selling parts of its sprawling business empire. These sales could have gone better. Despite talks with potential buyers, Evergrande has yet to find a buyer for its electric vehicle business. Some experts say buyers are waiting for a sell-off.

The second is that the Chinese real estate market is slowing, and the demand for new apartments is dwindling. It has also contributed to an overall slowdown in China's economic growth, which is stuck in a constant growth cycle that could further dent demand for Evergrande. Evergrande has nearly 800 unfinished projects in China, and as many as 1.6 million people are still waiting to move into their new homes. Evergrande has slashed the price of new apartments, but despite that, it has yet to attract new buyers. Evergrande's August sales were down 25% compared to last year's period. A large portion of the money Evergrande raised from pre-sale apartments still needed to be completed. Once the income from the assets is not enough to pay the interest, the result is a Ponzi scheme type of financing that can only be borrowed and repaid. This model worked until the Chinese government published three red lines. This directly dispelled the possibility of more borrowing while the Pandemic created a liquidity crisis.

Evergrande, which disclosed about \$300 billion of debt in mid-2021, has struggled to reach a deal with creditors after defaulting on international debt late last year. The company's Chief Executive, Shawn Siu, told Chinese media earlier this week that it would try to devise a plan to restructure its offshore debt by the end of this year. The latest news related to Evergrande is mostly asset sales. On September 8, 2022, a consortium of Chinese state-owned and private companies agreed to buy China Evergrande's minority stake in Shengjing Bank for \$1.05 billion, a deal that will help the troubled property developer resolve a debt dispute. As mentioned above, the Chinese government will unlikely help Evergrande keep its debt sustainability. In contrast, increasing state control is a more reliable measure for the future.



An unfinished building as an example of Evergrande's current projects. Photo Credit: Aly Song/Reuters

Conclusion

The latest news indicates a more optimistic sign. The stock prices of Chinese property developers increased significantly on September 15, 2022. There are growing signs that the Chinese Government is committed to propping up the country's sprawling real estate sector. Chinese President Xi Jinping has agreed to ease restrictions on home purchases by local governments except for the four first-tier cities of Beijing, Shanghai, Guangzhou, and Shenzhen. More than 120 cities or regions have eased requirements for using housing provident funds to buy homes so far this year, Chinese state media Securities Daily reported on the same day. However, it remains questionable

for investors and consumers. The Evergrande case implies the possibility for a giant real estate company to collapse suddenly and the Government's firmness not to bail it out. The Chinese Government has been striving to avoid the diffusion of such concerns. But the slow and unpredictable recovery of the Chinese economy is still imposing pressures on the market, leading to more cautious consumption and investment.

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